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IN THE

Supreme Court of The United States

OCTOBER TERM, 1981

HENRY CURTIS, ALBERT F. DUVAL, ROGER S. AHLBRANDT, FRED HERBOLZHEIMER, JR., BERNARD S. KUBALE, WILLIAM G. KUHNS, LOUIS H. RODDIS, JR., CHARLES M. WILLIAMS and HAMMERMILL PAPER COMPANY,
Petitioners,

v.

HARRY LEWIS,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTION PRESENTED

Has the Court of Appeals for the Third Circuit effectively nullified the requirements of Rule 23.1 of the Federal Rules of Civil Procedure governing stockholder derivative actions:

(a) By ruling, in conflict with this Court's decision in *Surowitz v. Hilton Hotels Corporation*, that the requirement that verification be based on careful investigation is satisfied by a plaintiff who only read a short article in *The Wall Street Journal* which did not describe any corporate misconduct?

(b) By expressly declining to follow the standard of the First and Ninth Circuits that the plaintiff may not be excused from making the required demand upon the directors when the challenged transaction, in this case the settlement of litigation, was not facially improper?

(c) By ruling, contrary to decisions of the Sixth and Eleventh Circuits, that the plaintiff's complete ignorance of the facts supporting his claim is not a factor to be considered in evaluating whether he adequately represents the interests of the shareholders?

LISTING OF PARENTS, SUBSIDIARIES AND AFFILIATES OF PETITIONER HAMMERMILL PAPER COMPANY PURSUANT TO SUPREME COURT RULE 28.1 AS AMENDED

Hammermill Paper Company owns 50 percent of the stock of Nortim Corporation, a Pennsylvania corporation with its head office in Erie, Pennsylvania. In addition, Hammermill Paper Company owns 60 percent of the Class A stock and approximately 6.7 percent of the Class B stock of Grays Harbor Paper Company, a Delaware corporation with its head office in Hoquiam, Washington.

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7A Wright & Miller, *Federal Practice and Procedure*, § 1833 at 393 (1972) 15

OPINIONS BELOW

The opinion of the court of appeals, reported at 671 F.2d 779, appears in Appendix A hereto. The opinion of the district court is not reported and appears in Appendix B hereto.

STATEMENT OF JURISDICTION

The judgment of the court of appeals was entered on March 3, 1982 and this petition for certiorari was filed within 90 days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Rule 23.1, Federal Rules of Civil Procedure: Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

STATEMENT OF THE CASE

On Wednesday, July 30, 1980, plaintiff, Harry Lewis ("Lewis"), read an article in *The Wall Street Journal* reporting on the settlement of litigation between Hammermill Paper Company ("Hammermill") and Carl C. Ichan ("Icahn"). Within forty-eight hours and without any additional investigation into the facts, Lewis verified a stockholder derivative complaint charging the directors of Hammermill with a waste of corporate assets.

The background to the settlement is that in the Spring of 1980 Icahn sought by a proxy contest to obtain a seat on the board of directors of Hammermill. There was a vigorous campaign by both parties to obtain proxies and several lawsuits ensued. On June 23 and 25, 1980, Lewis purchased two fifty-block shares of Hammermill stock.

On July 29, 1980, Icahn abandoned his effort to obtain a seat on the Hammermill board of directors when he entered into a settlement agreement with Hammermill ending all pending litigation between them. Under the terms of the settlement agreement, Hammermill paid $750,000 to Icahn to cover a portion of Icahn's expenses in the proxy contest.

On Wednesday, July 30, 1980, *The Wall Street Journal*, in a concise, two-column article on page 12, reported the settlement between Hammermill and Icahn. A copy of the article appears in Appendix C hereto.

On Friday, August 1, 1980, two days after Lewis read the article in *The Wall Street Journal*, he executed a verification of the complaint in this action. Lewis charged that the individual defendant-directors had violated their fiduciary duty owed to Hammermill, and that the payment of $750,000 to Icahn was "a waste and spoli-

ation of Hammermill's assets." The complaint was filed on Monday, August 4, 1980 in the District Court for the Western District of Pennsylvania, alleging diversity of citizenship between the parties.

In December of 1980, counsel for the defendants deposed Lewis. He testified that he read about the settlement agreement between Hammermill and Icahn in *The Wall Street Journal* on Wednesday, July 30, 1980. "Lewis admitted that his 'investigation' of the subject matter of the instant case was limited to his reading of a single journal article and that he verified the complaint two days after the newspaper article was published."[1] At his deposition Lewis was ignorant of most of the facts concerning the lawsuit or the transaction he was challenging, even failing to recognize the names of the individual defendants.

Defendants filed various motions, including motions to dismiss the complaint for failure to comply with Rule 23.1 of the Federal Rules of Civil Procedure[2] in the following respects: (1) Lewis's mere reading of a short article in *The Wall Street Journal* did not satisfy the verification requirement, (2) Lewis failed to allege reasons sufficient to excuse his failure to make the required demand upon Hammermill's board of directors, and (3) Lewis was not an adequate representative of the Hammermill shareholders. The trial court stayed all proceedings and ordered a preliminary hearing to determine whether Lewis met the requirements of Fed.R.Civ.P. 23.1.

Prior to the hearing scheduled by the court, Lewis filed a motion for leave to file an amended complaint and to add additional parties defendant. The proposed

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1 Appendix A at 16a.

2 Hereinafter referred to as "Fed.R.Civ.P. 23.1".

amended complaint claimed that the defendants were engaged in a scheme to maintain control of Hammermill.

At the preliminary hearing Lewis affirmed his deposition testimony described above and attempted to shift the responsibility for an investigation into the facts to his attorney, Abraham Markowitz. As the Third Circuit noted, however, Markowitz would not testify as to "what investigation he made."[3] Indeed, he testified: "I think the Wall Street Journal article itself, as far as I'm concerned, was sufficient basis for bringing a lawsuit."[4]

At the conclusion of the hearing the trial court granted the defendants' motions to dismiss, ruling that Lewis failed to satisfy the requirements of Fed.R.Civ.P. 23.1. Lewis appealed the trial court's dismissal to the United States Court of Appeals for the Third Circuit. A panel of the Third Circuit (Seitz, C.J., and Aldisert and Rosenn, JJ.) reversed the decision of the trial court and ordered the case remanded for further proceedings. The Third Circuit ruled:

(1) That the verification of the complaint was adequately supported solely by Lewis's reading of the article in *The Wall Street Journal* and that, therefore, "it [was] unnecessary to consider the investigation undertaken by his counsel, Markowitz [;]"

(2) That allegations in the amended complaint that the directors were engaged in a course of conduct to retain control of Hammermill were sufficient to excuse Lewis from making a demand upon the directors, even though the transaction in question was not facially improper; and

(3) That while Lewis " . . .displayed a complete ignorance of facts concerning the transaction that he

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3 Appendix A at 6a.

4 *Id.* at 7a.

was challenging[,]" this was not a factor to consider in determining whether Lewis could adequately represent the stockholders.

REASONS FOR GRANTING THE WRIT

Introduction

This case involves important issues concerning Rule 23.1 of the Federal Rules of Civil Procedure governing stockholder derivative actions. The decision of the Court of Appeals for the Third Circuit which is the subject of this petition conflicts with decisions of this Court and the First, Sixth, Ninth and Eleventh Circuits on these issues.

If the decision below is permitted to stand, the requirements of Rule 23.1 would be rendered a nullity and indeed could serve to encourage rather than discourage the proliferation of strike suits. Every newspaper article reporting a corporate transaction could become the basis for a derivative action. There would be no need for either a plaintiff or his counsel to conduct a responsible and reasonable investigation of the transaction to be challenged. Suits could be brought, as here, in as short a period of time as it takes to read a newspaper article and draft a complaint. Finally, if the requirement of a demand were as easily avoided as the Third Circuit holds, there would be almost no restraint on counsel or prospective plaintiffs and recourse to non-litigation, intra-corporate resolution of disputes would never be attempted.

This Court has not addressed the important policy considerations raised by the decision below since at least 1966. Each of the questions upon which certification has been requested is frequently put in issue by both plaintiffs and defendants in derivative actions. The law

which has evolved to resolve them is confusing and unclear —the product of often widely divergent responses by different circuit courts. This confusion will only be exacerbated by the Third Circuit's decision here which sets Rule 23.1 on its head. It is vital that this Court grant certification to restore some degree of harmony and reduce the possibility that the result of a particular action will depend upon a party's choice of a forum.

I. The Decision Below That The Verification Requirement Can Be Met By Reading A Short Article In *The Wall Street Journal* Conflicts With This Court's Decision In *Surowitz v. Hilton Hotels Corporation.*

Fed.R.Civ.P. 23.1 requires that a complaint in a shareholder's derivative action be verified. This, of course, is in contrast with virtually all other complaints filed in the federal courts, which need not be verified but, rather, only signed by counsel.[5] This exceptional requirement reflects important policy considerations and an intent on the part of the drafters of the Federal Rules to provide protection against derivative suits based on insubstantial investigation.[6]

Justice Black, writing for this Court in *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 371 (1966), stated that Fed.R.Civ.P. 23.1 "was originally adopted and has served since in part as a means to discourage 'strike suits' by

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5 Fed.R.Civ.P. 11.

6 *See In re Kaufman Mutual Fund Actions*, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973) ("Rule 23.1 is not an ordinary, but an exceptional rule of pleading, serving a special purpose, and requiring a different judicial approach."). *Compare* Fed.R.Civ.P. 23.1 *with* Fed.R.Civ.P. 9(b)(requiring fraud to be pleaded with specificity) and *Segal v. Gordon*, 467 F.2d 602 (2d Cir. 1972), and *McFarland v. Memorex Corp.*, 493 F.Supp 631 (N.D. Cal. 1980), where complaints based upon *Wall Street Journal* articles were held to be violative of Fed.R.Civ.P. 9(b).

people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate management to settle worthless claims in order to get rid of them."

Surowitz was a stockholder's derivative action brought against the officers and directors of Hilton Hotels Corporation charging that the defendants had defrauded the corporation. The plaintiff, Mrs. Surowitz, was "a Polish immigrant with a very limited English vocabulary and practically no formal education." 383 U.S. at 368. Although Mrs. Surowitz verified the complaint in technical compliance with Fed.R.Civ.P. 23(b),[7] she demonstrated at her deposition that she had almost no knowledge of the basis of the allegations in the complaint. Rather, she testified, she had acted entirely on the advice of her investment counselor and an attorney. In marked contrast to the instant case, their extensive investigations had occurred over the course of a year and had included a meeting with counsel for the defendants to discuss the transactions in question. This Court concluded that affidavits of Mrs. Surowitz's advisors detailing their investigations satisfied the verification requirement of Fed.R.Civ.P. 23.1 and its purpose to discourage strike suits, since the charges in the complaint were based "... on reasonable beliefs growing out of a careful investigation." 383 U.S. at 373.[8]

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7 Fed.R.Civ.P. 23(b) was redesignated Fed.R.Civ.P. 23.1 in 1966.

8 Cases decided subsequent to *Surowitz* have quite properly applied this standard to require that before a derivative action may go forward, the court must be satisfied that the plaintiff or his representative has made a responsible investigation into the allegations in the complaint. *See Waldman v. Carey*, 82 F.R.D. 469, 471 (E.D.Pa. 1979) (purpose of verification requirement is to discourage suits by derivative plaintiffs who have no reason to believe allegations in complaint are true); *Cohen v. Bloch*, [1979-80 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶ 97,176 (S.D.N.Y. Nov. 14, 1979) (discovery permitted into extent of investigation performed on behalf of plaintiff); *Rogosin v. Steadman*, 71 F.R.D. 514, 519 (S.D.N.Y. 1976) (complaint dismissed because,

In refusing to apply this standard and permitting this derivative action to proceed on the sole basis of the reading of a *Wall Street Journal* article which merely describes the settlement of litigation arising out of a proxy contest, the Third Circuit's decision reduces the verification requirement to a meaningless formality.

II. The Decision Below That The Court Need Not Consider The Nature Of The Challenged Transaction In Determining Whether Plaintiff May Be Excused From Making A Demand Conflicts With Decisions By The First And Ninth Circuits.

The First Circuit Court of Appeals has held that in determining whether a plaintiff is excused from making a demand upon directors, the Court should consider (a) whether the transaction on its face is lacking in any proper corporate purpose, and (b) whether the directors are "interested". *Heit v. Baird*, 567 F.2d 1157 (1st Cir. 1977). In the instant case, the Court of Appeals expressly refused to follow the First Circuit and ruled that the Court should not give any consideration to the nature of the transaction in question in determining whether plaintiff is excused from making a demand. Petitioners submit that the Third Circuit's refusal to consider the nature of the challenged transaction misconceives the important purposes of the demand requirement.

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inter alia, there was no showing "that a responsible investigation was carried out and its results communicated to these plaintiffs sufficient to permit them to responsibly institute and stand behind the complaint"), and 65 F.R.D. 365, 367 (S.D.N.Y. 1974) ("fundamental to Rules 11 and 23.1 as well as to the conclusion of *Surowitz*, that the Court be assured that some person, party, attorney, advisor, or otherwise has responsibly investigated the allegations at the behest of the named plaintiff, who then stands behind the merits of the complaint"); *Ports v. Home Federal Savings and Loan Association*, 409 F.Supp. 753, 754 (N.D.Ill. 1976) ("Before a court can proceed with a derivative suit, it must be assured that the plaintiff or some other person has investigated the charges and found them to have substance.").

The reason for the demand requirement is not merely to allow the corporation to pursue the claim through litigation. Rather, Fed.R.Civ.P. 23.1 requires a derivative plaintiff to allege with particularity the efforts made "to obtain the action he desires from the directors." Such general language obviously is designed to allow the directors to resolve the dispute through any number of methods, only one of which would be to pursue the claim in litigation in its own behalf. To deny the directors the opportunity to remedy the suspected wrong through intracorporate and extra-judicial means, or the opportunity to explain the reasons for entering into a transaction which is not improper on its face, severely dilutes the effect of the demand requirement and undoubtedly leads to wasteful litigation.[9]

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9 Courts and commentators alike have recognized that an important purpose of the demand requirement is to provide management with the opportunity to resolve internally matters of shareholder dispute. *Hawes v. Oakland*, 104 U.S. 450, 460-61 (1882)(plaintiff "should show to the satisfaction of the court that he has exhausted all the means within his reach to obtain, within the corporation itself, the redress of his grievances, or action in conformity to his wishes. He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part. . . ."); *Mills v. Esmark, Inc.*, 91 F.R.D. 70, 72 (N.D. Ill. 1981) ("The dissident shareholder is provided with an opportunity to achieve his goal without incurring the expense of litigation; the directors of the corporation are allowed to occupy their status as managers of the corporation's affairs; the corporation is left to clean its own house, free from judicial entanglements; and the courts are relieved of the burden of prematurely resolving intracorporate disputes."); *Weiss v. Temporary Investment Fund, Inc.*, 516 F.Supp. 665, 670 (D. Del. 1981) ("The directors . . . might be in a position to resolve the grievance without litigation, or to persuade the complaining shareholder that the claim is unjustified or that its prosecution would not be in the best interests of the company.") (footnote omitted); *see also Gartenberg v. Merrill Lynch Asset Management, Inc.*, 91 F.R.D. 524, 526 (S.D.N.Y. 1981); *Lerman v. ITB Management Corp.*, 58 F.R.D. 153, 157-58 (D. Mass. 1975); *Weiss v. Sunasco, Inc.*, 316 F.Supp. 1197, 1203 (E.D.Pa. 1970); Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U.Chi.L.Rev. 168, 173 (1976) (referred to herein as "Chicago Note"); Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 Harv. L.Rev. 746, 748-49 (1960) (referred to herein as "Harvard Note").

In its Opinion, the Third Circuit acknowledged that in *Heit v. Baird* the First Circuit "held that allegations of futility substantially similar to those in this case fail to satisfy the demand requirement of rule 23.1." Appendix A at 13a. The derivative plaintiff in *Heit v. Baird* challenged a transaction which was approved by the board of directors allegedly for the sole purpose of thwarting a threatened contest for control of the corporation. The plaintiff sought to have demand excused by allegations nearly identical to those in this case. The First Circuit recognized that the transaction might have been consummated for any one of several possible legitimate corporate purposes and stated: "As the complaint fails to set forth facts showing that a majority of the directors . . . engaged in a facially improper transaction, we hold that the failure of the plaintiff to make a demand on the directors before commencing this suit was unexcused, and dismissal of the case for noncompliance with Rule 23.1 was proper." *Id.* at 1162 (footnote omitted). *See Grossman v. Johnson*, 674 F.2d 115, 125 (1st Cir. 1982) (held, allegations of director interestedness not sufficient to excuse demand because *"Heit v. Baird* . . . indicates that the bare possibility or mere allegation that the directors could have a self-interested purpose . . . is not enough if, as in this case, there can be valid corporate reasons for taking the position challenged in the complaint . . . ."). The Ninth Circuit followed *Heit* in *Greenspun v. Del. E. Webb Corp.*, 634 F.2d 1204, 1210 (9th Cir. 1980), and refused to excuse demand because, *inter alia*, none of the alleged actions "was completely undirected to a corporate purpose."

Finally, with respect to the demand issue, and the reasons for which the requirement should be excused, it must be observed that this is a subject of great

uncertainty[10] and the practice in this area of the law would benefit substantially from this Court's guidance. The demand issue is a recurring one which arises in many, if not most, of the large number of derivative actions which are brought in the federal courts.

III. The Decision Below That Plaintiff's Complete Ignorance Of The Facts Supporting The Claim Should Not Be Considered In Evaluating The Adequacy Of His Representation Of The Shareholder Class Conflicts With Decisions By The Sixth And Eleventh Circuits.

This Court has held that a shareholder who brings a derivative action has a fiduciary relationship with respect to his fellow shareholders, since "[t]he interests of all in the redress of the wrongs [alleged] are taken into his hands [and are] dependent on his diligence, wisdom and integrity." *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541, 549 (1949). This Court went on to hold that:

> "[W]hile the stockholders have chosen the corporate director or manager, they have no such election as to a plaintiff who steps forward to represent them. He is a self chosen representative and a volunteer champion. The Federal Constitution does not oblige the

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10 *See* Appendix A at 11a ("Courts disagree about the level of the directors' involvement in the challenged transaction necessary to excuse demand."); *Zilker v. Klein*, 510 F.Supp. 1070, 1073 (W.D. Okl. 1981) ("Courts have not been uniform in their approach to the question whether a demand should be excused if the transactions complained of were approved by the board of directors."); *Abbe v. Goss*, 411 F.Supp. 923, 924 (S.D.N.Y. 1975) ("The law is indeed unclear and imprecise in defining what constitutes sufficient 'futility' to excuse a Rule 23.1 demand."); Chicago Note, *supra*, at 170 n.14 (and cases cited therein)("The inconsistent state of the case law interpreting Rule 23.1 has been acknowledged by the courts."); Harvard Note, *supra*, at 747 (discussing "widely divergent applications" of the demand requirement).

> state to place its litigating and adjudicating processes at the disposal of such a representative, at least without imposing standards of responsibility, liability and accountability which it considers will protect the interests he elects himself to represent."

Id. at 549-50. To accomplish this end, Fed.R.Civ.P. 23.1 requires that a derivative plaintiff must "fairly and adequately" represent the interests of the other shareholders.

In the instant case the Court of Appeals for the Third Circuit stated: "At his deposition, taken over four months after he verified the complaint, [plaintiff] Lewis displayed a complete ignorance of facts concerning the transaction that he was challenging." Appendix A at 20a. Defendants (Petitioners herein) alleged that a plaintiff displaying such complete ignorance of the facts could not adequately represent the stockholder class as required by Fed.R.Civ.P. 23.1.

The Court of Appeals for the Third Circuit rejected this claim on the grounds that the plaintiff's complete ignorance of the facts is not a factor to be considered in evaluating the adequacy of his representation. Rather, the Court relied on *Wetzel v. Liberty Mutual Insurance Co.*, 508 F.2d 239 (3d Cir.), *cert. denied*, 421 U.S. 1011 (1975), which ruled that the only factors to be considered in evaluating adequacy of representation are the following: "(a) the plaintiff's attorney must be qualified, experienced and generally able to conduct the proposed litigation, and (b) the plaintiff must not have interests antagonistic to those of the class." 508 F.2d at 247.

In so ruling, the Court of Appeals for the Third Circuit conceded that there are cases to the contrary and cited *Roussel v. Tidelands Capital Corp.*, 438 F. Supp. 684

(N.D.Ala. 1977) and *Apanewicz v. General Motors Corp.*, 80 F.R.D. 672 (E.D.Pa. 1978). However, there are also recent decisions by the Courts of Appeal for the Sixth and Eleventh Circuits finding that the plaintiff's knowledge of the facts is an element to be considered in evaluating adequacy of representation. *Rothenberg v. Security Management Co., Inc.*, 667 F.2d 958 (11th Cir. 1982); *Davis v. Comed, Inc.*, 619 F.2d 588 (6th Cir. 1980).

In *Rothenberg v. Security Management Co., Inc.*, *supra*, the Eleventh Circuit listed five factors considered by the courts in determining whether a derivative plaintiff is a fair and adequate representative.[11] The court then held that the district court had not abused its discretion in ruling that the derivative plaintiff was not a fair and adequate representative, since the record showed that the plaintiff was unfamiliar with many of the allegations in the complaint and what she did know was derived largely from her attorney. *See also Davis v. Comed, Inc.*, *supra*, 619 F.2d at 593-94, where the court listed a variety of factors to consider in evaluating the representation of a derivative plaintiff, one factor being "plaintiff's unfamiliarity with the litigation." Further, a

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11 "Whether a particular plaintiff will fairly and adequately represent the interests of other similarly situated shareholders as required by Rule 23.1 turns upon the total facts and circumstances of each case. *Davis v. Comed, Inc.*, 619 F.2d 588, 593-94 (6th Cir. 1980). Some of the factors considered by courts include: (1) indications that the plaintiff is not the true party in interest, *e.g.*, *Nolen v. Shaw-Walker Co.*, 449 F.2d 506, 509 (6th Cir. 1971); (2) the plaintiff's unfamiliarity with the litigation and unwillingness to learn about the suit, *e.g.*, *Davis v. Comed, Inc.*, *supra*, 619 F.2d at 593; *Levine v. Berg*, 79 F.R.D. 95, 98 (S.D.N.Y. 1978); (3) the degree of control exercised by the attorneys over the litigation, *e.g.*, *In re Com. Oil/ Tesoro Pet.Sec.Lit.*, 484 F. Supp. 253, 263 (W.D.Tex. 1979); *Levine v. Berg*, *supra*, 79 F.R.D. at 98; *In re Goldchip Funding Co.*, 61 F.R.D. 592, 594-95 (M.D.Pa. 1974); (4) the degree of support received by the plaintiff from other shareholders, *see Schupack v. Covelli*, 512 F.Supp. 1310, 1312 (W.D.Pa. 1981); and (5) the lack of any personal commitment to the action on the part of the representative plaintiff, e.g., *Cohen v. Bloch*, 507 F. Supp. 321, 326 (S.D.N.Y. 1980)." 667 F.2d at 961.

number of district courts have recognized that a plaintiff's knowledge of the facts of a case is essential to his effectiveness and adequacy as a representative of the shareholders or class members on whose behalf the suit is brought.[12]

These conflicts justify the grant of certiorari to review the judgment below. The question whether a derivative plaintiff's familiarity with the facts of a case bears upon the requirement that he be an adequate representative is a particularly important one in light of the rule that the standards in determining the adequacy of the representative in a derivative suit are equally applicable to determining the adequacy of a class representative under Fed.R.Civ.P. 23. *See G.A. Enterprises, Inc. v. Leisure Living Communities, Inc.*, 517 F.2d 24, 26 n.3 (1st Cir. 1975); 7A Wright & Miller, *Federal Practice and Procedure*, § 1833 at 393 (1972).

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12 *In re Goldchip Funding Co.*, 61 F.R.D. 592, 594-95 (M.D. Pa. 1974); *Apanewicz v. General Motors Corp.*, 80 F.R.D. 672, 678 (E.D.Pa. 1978) (Rule 23); *Levine v. Berg*, 79 F.R.D. 95, 98 (S.D.N.Y. 1978) (Rule 23); *Greenspan v. Brassler*, 78 F.R.D. 130, 133-34 (S.D.N.Y. 1978) (Rule 23); *Seiden v. Nicholson*, 69 F.R.D. 681, 688-89 (N.D.Ill. 1976); *cf. Dura-Bilt Corp. v. Chase Manhattan Corp.*, 89 F.R.D. 87, 102-03 & n.1 (S.D.N.Y. 1981) (Rule 23)(and cases cited and discussed therein) (court ruled that plaintiffs were adequate representatives despite "unfamiliarity" and acknowledged that "there are numerous conflicting decisions on this issue").

CONCLUSION

Since the decision below is in direct conflict with the decisions of this Court and of other Courts of Appeals on the proper interpretation and application of Rule 23.1 of the Federal Rules of Civil Procedure and since the decision raises significant and recurring policy considerations, a writ of certiorari should issue to review the judgment and opinion of the Third Circuit.

Respectfully submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 81-2055

HARRY LEWIS,

Appellant

v.

HENRY CURTIS, ALBERT F. DUVAL, ROGER S. AHLBRANDT, FRED HERBOLZHEIMER, JR., BERNARD S. KUBALE, WILLIAM G. KUHNS, LOUIS H. RODDIS, JR., CHARLES M. WILLIAMS, and HAMMERMILL PAPER COMPANY,

Appellees

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA
(D.C. Civil No. 80-0125 Erie)

Argued January 21, 1982
Before: SEITZ, *Chief Judge*,
ALDISERT and ROSENN, *Circuit Judges*
(Filed March 3, 1982)

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OPINION OF THE COURT

SEITZ, *Chief Judge.*

Plaintiff Harry Lewis appeals from a final order of the district court dismissing his complaint and denying his motion for leave to amend. This court has jurisdiction under 28 U.S.C. § 1291 (1976).

I.

It is undisputed that, in 1980, Carl C. Icahn sought by a proxy contest to obtain a seat on the board of directors of Hammermill Paper Company, a Pennsylvania corporation. Icahn abandoned his contest on July 29 after entering into a settlement agreement with Hammermill ending all the pending litigation between them; Hammermill agreed to pay Icahn $750,000 to cover his expenses in the proxy contest. On July 30, *The Wall Street Journal*, in a concise, two-column article, reported the settlement between Hammermill and Icahn. On August 1, Lewis verified the complaint in the present action, charging that the directors had violated their fiduciary duty to Hammermill because the payment to Icahn was a "waste and spoliation of Hammermill's assets" and demanding that the individual defendants be required to pay to Hammermill $750,000 for the damages sustained by it. The complaint was filed on August 4.

In December 1980, counsel for defendants deposed Lewis. Lewis testified that he read about the settlement agreement in *The Wall Street Journal* on July 30. He then called his attorney, Abraham Markowitz, and left the investigation of this matter entirely to him. Later during the deposition, however, Lewis testified that he verified the complaint only after Markowitz apprised him of the results of the investigation. Counsel for Hammermill asked questions concerning the facts upon which Lewis based his verification and, in each case, Markowitz instructed Lewis not to answer on the ground of the attorney-work-product protection. For example, the original complaint states that the president of Hammermill completely dominates the selection process of the board of directors. When asked the basis for verifying this allegation, Lewis testified only that he made

the allegation upon "information given to me by my attorney" and, on Markowitz' advice, refused to disclose that information. At the deposition of Markowitz, he, too, refused to describe any facts developed in the course of investigation.

Defendants filed various motions, including a motion to dismiss the complaint on the ground that it failed to comply with rule 23.1 of the Federal Rules of Civil Procedure because: (1) the complaint failed to state with particularity the efforts, if any, Lewis made to require that the $750,000 be repaid to Hammermill, and the reasons for failing to obtain such action or for not making the effort; (2) Lewis does not fairly and adequately represent the interests of the Hammermill shareholders; and (3) Lewis' failure to investigate personally the underlying facts makes his verification of the complaint a sham. With these motions before it, the district court stayed all proceedings and ordered a preliminary hearing. Before the preliminary hearing, Lewis filed a motion to amend his complaint. The amended complaint attempts to set forth additional grounds why it would have been futile to request the board of directors to correct the alleged wrong in this case.

At the hearing, Lewis' local counsel, Michael Malakoff, asked: "Your Honor, may we have an offer of proof as to the purpose of this unusual proceeding?" The district court replied:

> This is a court proceeding to see whether rule 23 has been [complied with] by counsel in this case.... I want to see what the facts of the situation were at the time it was drawn and when the information came to him and all that sort of thing and what was imparted to him. Fact, now. I'm not talking about any

question here about privilege. So just sit down, will you?

Markowitz was called to the stand and examined by defendants' counsel. Markowitz accepted full responsibility for the investigation of the facts, but repeated the position he had taken at Lewis' deposition that he was not required to provide any information concerning his investigation. The district court did not consider the attorney-work-product protection applicable:

> [O]n the face of this complaint and the way it was executed, lack of verification ..., it raises certainly a suspicion that the complaint may be just a strike complaint. It's subject to investigation by the Court, by me. I'm not going to let the thing go forward unless I'm satisfied that some investigation has been made.

The court subsequently asked Markowitz what documents he used to prepare the complaint.

> The Court: What documents are you willing to submit, your file? You don't want to submit your file, do you?
>
> Markowitz: That would be in violation of my refusal to answer.
>
> Malakoff: May I ask the witness certain questions?
>
> The Court: No. I'm examining him. . . .
>
> Markowitz: May I consult with Counsel, please, for just two minutes?
>
> The Court: An experienced lawyer like you? Tell me the truth of the matter. Did you consult any document or didn't you?
>
> Markowitz: I certainly did, your Honor.

The Court: Tell me what one.

Markowitz: The documents are all on that table.

The Court: Bring them up and hand them to me. One by one we will look at them. Do you want to bring them up?

Malakoff: May I consult with my client, your Honor?

The Court: What is this, a charade? This is a hearing here in the Federal Court. If you want to carry on that way, I'm willing to grant the motion to dismiss.

The district court then announced that he would give Lewis and Markowitz ten minutes to review their position and said: "If you're not prepared to relate to this Court your investigation with particularity as to what you found out and testify about it, we'll conclude the hearing."

After the recess, Malakoff indicated that Markowitz was prepared to identify each of the documents he reviewed and the persons he consulted from July 30 to August 1 in preparing the complaint: Markowitz produced his presuit investigatory file and testified that, between July 30 and August 1, 1980, he examined Icahn & Company's 13-D form, and amendments thereto, on file with the Securities and Exchange Commission; Hammermill's 10-K for 1979; the proxy statements of Icahn and Hammermill; the complaints filed in connection with the proxy contest; and the files of a similar case in which Lewis was involved. He would not, however, testify about "what investigation he made."

The Court: If he [Markowitz] isn't going the full way, we might as well stop, too, because he can't make the rules here and you can't, what I'm to learn.

Malakoff: I believe the Supreme Court has made the rules.

The Court: Maybe you'd better go there. Maybe you will. You will have a chance, I think. I think you'll have a chance.

Malakoff: I believe that he's committed to —

The Court: Sit down, will you?

Markowitz also testified, however, that: "I did not make any investigation. I think the Wall Street Journal article itself, as far as I'm concerned, was sufficient basis for bringing a lawsuit."

The Court: You based your judgment, then, on the Wall Street article?

Markowitz: On forty years of experience, your Honor, please.

The Court: You had a great suspicion, didn't you?

Markowitz: I didn't have any suspicion.

The Court: So you brought another strike suit, didn't you?

In view of Markowitz' refusal to explain the relevance of some of the documents, the district court refused to permit some of them to be admitted into evidence: "Then we'll not hear any more documents if he isn't going to respond by saying they influenced him. We'll not hear any more about useless documents in the record." The district court announced orally the same day that it intended to dismiss this action with prejudice.

II.

Lewis makes two principal arguments in support of his contention that the district court's order is error: (1) the original complaint complied with the requirements of

rule 23.1, and thus the district court should not have dismissed it; and (2) the district court erred in refusing to allow Lewis to file an amended complaint. Because it was error for the district court not to permit Lewis to file his amended complaint, we will not consider whether the original complaint complied with rule 23.1. We thus proceed to discuss the district court's refusal to permit amendment.

A.

Rule 15(a) of the Federal Rules of Civil Procedure directs that leave to amend "shall be freely given when justice so requires." Whether to grant or to deny leave to amend, however, is within the discretion of the district court, and the district court's decision to deny leave to amend is thus subject to reversal only for abuse of that discretion. *See Cornell & Co. v. OSHRC*, 573 F.2d 820, 823 (3d Cir. 1978). In denying Lewis' motion to file an amended complaint, the district court stated: "[T]he amended complaint as submitted is conclusory and lacks particularity and demand and is not supported by any investigative facts whatsoever." Assuming that a court may deny leave to amend if the proposed complaint is legally insufficient on its face, the issue before us is whether the district court abused its discretion in failing to find that the amended complaint sufficiently meets the requirements of rule 23.1 and cures the defects, if any, in that complaint.

B.

Defendants argue that Lewis' general, conclusory allegation that the directors participated in the transaction in question does not excuse demand under rule 23.1. Rule 23.1 expressly requires that a shareholder's deriva-

tive complaint allege either that a demand was made upon the directors to take the desired action or that reasons exist for failing to make such a demand. The demand requirement is based on the premise that a corporation's decision to enforce a right on its own behalf is a matter of business judgment within the domain of the board of directors. *See Cramer v. GT&E Corp.*, 582 F.2d 259, 274-75 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979); *Landy v. FDIC*, 486 F.2d 139, 146 (3d Cir. 1973), *cert. denied*, 416 U.S. 960 (1974). Because of the important policies behind the rule, "the demand requirement of Rule 23.1 should be rigorously enforced...." *Cramer*, 582 F.2d at 275.

The amended complaint states that Lewis made no demand and that demand would have been futile because all individual defendants were directors of Hammermill and had knowledge of, participated in, and approved the acts and transactions referred to in the complaint; therefore, the individual defendants would, in effect, be called upon to authorize a suit against themselves. The amended complaint alleges with particularity not only the approval by the directors of the payoff, but also alleges in detail a larger scheme by the directors to retain control of Hammermill. First, all of the individual defendants had been directors of Hammermill since 1976. Second, seven specified defendants, in concert with the other individual defendants, embarked upon a plan to frustrate and prevent any attempts to obtain control of Hammermill by third parties or to cause its merger or liquidation, to entrench themselves in their positions, and to control Hammermill. This plan to frustrate outside attempts to obtain control of Hammermill included: (a) long-term employment contracts for six of the directors in 1976; (b) an amendment to Hammermill's certifi-

cate of incorporation requiring the affirmative vote of 85% of the outstanding shares of stock for the authorization of any transaction with the owner of 20% or more of Hammermill stock; and (c) the adoption of an amendment of the By-Laws on March 31, 1980 reducing the number of directors from twelve to eight.

Third, Hammermill sued Icahn, alleging violations of the federal securities laws, the same day it reduced the board's size. Fourth, Icahn and defendant Duval had meetings of which all of the individual defendants knew or were advised. Finally, the settlement agreement was eventually approved by the board of directors. The amended complaint also contains detailed allegations concerning the financial interests of various directors, their status as executive officers of Hammermill, their tenure in office, and their control of the activity of Hammermill. In sum, it is clear that Lewis alleges that: (1) all of the board engaged in a self-interested act, *i.e.*, the "payoff" to retain control of Hammermill; (2) all of the board members are "interested" in the transaction; and (3) there were prior acts furthering their objective to frustrate outside attempts to obtain control of Hammermill. The issue before us is whether the district court abused its discretion in refusing to permit leave to amend because this amended complaint fails to allege with particularity reasons why demand was not necessary.

Whether Lewis has complied with the demand requirement of rule 23.1 involves solely an examination of the amended complaint. *See In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 263 & n.4 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). Courts will excuse the derivative plaintiff from the demand requirement when his complaint alleges that a majority of the directors have participated in the underlying wrongdoing or that the

board is controlled by the alleged wrongdoers. *See Untermeyer v. Fidelity Daily Income Trust*, 580 F.2d 22, 23 (1st Cir. 1978); *Cathedral Estates v. Taft Realty Corp.*, 228 F.2d 85, 88 (2d Cir. 1953). To preserve the vitality of rule 23.1, however, courts have refused to excuse demand simply because a majority of the directors are named in the complaint and have cautioned that mere conclusory allegations of director wrongdoing will not suffice to excuse demand. *See Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204, 1209-10 (9th Cir. 1980); *Heit v. Baird*, 567 F.2d 1157, 1162 (1st Cir. 1977); *Kauffman*, 479 F.2d at 264.

Courts disagree about the level of the directors' involvement in the challenged transaction necessary to excuse demand. The majority view is that the mere approval of an allegedly injurious corporate transaction, absent self-interest or bias by a majority of the board, is insufficient to excuse demand. *See Greenspun*, 634 F.2d at 1210; *Heit*, 567 F.2d at 1162; *Kauffman*, 479 F.2d at 265. *But see Liboff v. Wolfson*, 437 F.2d 121, 122 (5th Cir. 1971)(per curiam). *See generally* Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 176-77 (1976) (*Kauffman* represents the preferred view). Moreover, the cases are in agreement that the allegation that demand upon the directors would be futile because the directors "would be suing themselves" is not alone sufficient to excuse demand. *See Heit*, 567 F.2d at 1162; *Weiss v. Temporary Investment Fund, Inc.*, 516 F.Supp. 665, 672-73 (D.Del. 1981); *Kusner v. First Pennsylvania Corp.*, 395 F. Supp. 276, 284-85 (E.D. Pa. 1975), *rev'd on other grounds*, 531 F.2d 1234 (3d Cir. 1976).

Control of the board by interested members, or participation by board members in a challenged transaction, may not be, in some circumstances, sufficient alone to

make demand futile. A demand on the board should not be required, however, where the allegations of the complaint permit the inference by the court that the directors upon whom demand would be made lack the requisite distinterestedness to determine fairly whether the corporate claim should be pursued. Whether the board is sufficiently interested so that a court will not defer to its judgment to pursue the derivative suit is an issue that must be faced at some point. *See* Buxbaum, *Conflict-of-Interests Statutes and the Need for a Demand on Directors in Derivative Actions*, 68 Calif.L.Rev. 1122 (1980) (when the challenged conduct involves self-dealing, the demand-on-directors requirement is a species of demurrer). There is no reason why a court, in deciding whether a board is sufficiently interested to excuse demand, should not be informed by the same factors used to determine whether a court should defer to the board's decision not to pursue the action. The board will lack such disinterestedness if plaintiff's allegations, taken as true, would show that, under state law, a court should not defer to the board's decision not to pursue the lawsuit. *Cf. Burks v. Lasker*, 441 U.S. 471, 480 (1979)(whether a board is able to assert protection of the business judgment rule must be decided with reference to state law).[1] To require otherwise would force plaintiff to make a demand that, in many cases, would but delay suit and remedy.

Some courts have suggested that directors may not be sufficiently interested in a transaction to excuse demand, yet are interested enough to be unable to assert the protection of the business judgment rule. *See, e.g.*,

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[1] If plaintiff alleges a violation of federal law, *Burks* requires that the court must, after determining that state law requires deferral to a board's decision not to pursue the lawsuit, also determine "whether such a state rule [is] consistent with the policy" underlying federal law. 441 U.S. at 480.

Clark v. Lomas & Nettleton Financial Corp., 625 F.2d 49, 54 n.5 (5th Cir.), *cert. denied*, 450 U.S. 1029 (1980); *Galef v. Alexander*, 615 F.2d 51, 59 (2d Cir. 1980); *Heit*, 567 F.2d at 1162 n. 4. On the other hand, formulating different standards for the two issues is in fact difficult without adopting the rigorous demand requirement of the United States Court of Appeals for the First Circuit in *Heit*. In *Heit*, the court held that allegations of futility substantially similar to those in this case fail to satisfy the demand requirement of rule 23.1.[3] Making a demand was not excused in Heit because the sale of stock challenged was not alleged with particularity to be at a grossly inadequate price. Thus, the court stated that nothing more than erroneous business judgment was asserted. *Id.* at 1161-62. The court concluded that, in the absence of a showing that a majority of the board engaged in " 'a transaction completely undirected to a corporate purpose,' " demand on the directors was required. *Id.* at 1162.

We do not think that, to excuse demand, plaintiff must allege that the transaction could not under any circumstances ultimately be considered the product of business judgment. Rather, the court, in determining whether demand is necessary, should consider whether a demand on the directors would be likely to prod them to correct a wrong. With this as the focus, the interested-

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[3] The plaintiff in *Heit* alleged that demand upon the board of directors implicated in the transaction would be futile because of the following reasons:

> No demand has been made by plaintiff upon the directors of B-A to institute and prosecute this action because all of said directors are named as defendants herein, and they have participated in, authorized and approved and are personally liable for the wrongs complained of in this action; and any demand upon them to [institute] such an action would have been futile and useless and that thereby said defendants would have been required to institute an action against themselves.

567 F.2d at 1159.

ness of the directors in the transaction is more relevant to our inquiry that the character of the alleged wrong. To the extent that *Heit* requires that it be alleged that a majority of directors be involved in a facially improper transaction before demand will be excused, we decline to follow it. *See Untermeyer*, 580 F.2d at 24 ("[T]he distinction made in *Kaufman* and *Heit* between actions that could, prima facie, serve a legitimate corporate purpose and those that could not . . . was made for the purpose of determining whether a participating trustee was sufficiently unconnected, or 'disinterested,' to be presumptively responsive to demand. . . .").

Thus, we do not think that we should apply different standards of "interestedness" to cases in which plaintiff has made no demand and to those in which a demand has been made and rejected. In determining whether a court should defer to a board's decision not to initiate a suit against interested directors, it is necessary to determine whether the directors' decision is consistent with their fiduciary duty. *See Evans v. Diamond Alkali Co.*, 315 Pa. 335, 172 A. 678, 679 (1934). The business judgment rule protects directors from liability for honest mistakes of judgment, *see Selheimer v. Manganese Corp. of America*, 423 Pa. 563, 224 A.2d 634, 644 (1966), but it presupposes a decision that is honest, unbiased, and in compliance with fiduciary duties, *see Cramer*, 582 F.2d at 274; *Miller v. AT&T Co.*, 507 F.2d 759, 762 (3d Cir. 1974). Thus, to determine whether a decision not to sue the interested directors would be immunized from scrutiny, it is necessary to determine whether the directors who would make that decision were involved in the allegedly wrongful transaction.

Even if we were to concede that the case alleged here, "a waste and spoliation of the assets," is typically a

difficult case to sustain, the mere desire to avoid a possibly futile, expensive proceeding should not lead courts to block its continuation through a demand-on-directors requirement. Taking plaintiff's allegations as true, the directors to be sued would control the response to any demand. In this situation, trial—or at least embarking on the road to trial—is required. To impose the bar of the demand requirement would largely be to create a pleading defense to a fact dispute. To prove his allegations, plaintiff here must still show that all of the directors are interested in the transaction and that the payment was "a waste and spoliation of the assets." Corporate directors should not, at the expense and inconvenience of an innocent corporation and its shareholders, be spared the trouble of responding to a complaint that states a cause of action, but may be deficient of proof. *See* Buxbaum, *supra*, at 1130.

The complaint here alleges that, not only did all the directors participate in and approve of the challenged activity, but the challenged activity is a self-interested transaction. It sets forth in detail a scheme, of which this transaction is alleged to be a part, furthering the directors' interest in perpetuating their control of Hammermill. When a complaint alleges, as this amended complaint does, that all the directors participated in and approved of a self-interested transaction, and sets forth in detail facts showing that the directors are indeed interested, any demand must be presumed futile. *Cf.* Note, *supra*, at 181-82 ("Participation by the directors in the challenged transaction absent self-interest or bias should not excuse [demand])."). *See also Vernars v. Young*, 539 F.2d 966, 968 (3d Cir. 1976) (finding demand necessary "where the allegations do not make charges against a majority of a Board"). Indeed, allegations similar to

those in this case have been found as a matter of law to excuse demand under rule 23.1. *See Liboff*, 437 F.2d at 122. The district court's failure to permit Lewis to amend his complaint because it failed to advance with particularity reasons for not making a demand was thus an abuse of discretion.

C.

The district court, in denying Lewis' motion to amend, also stated that the amended complaint "is not supported by any investigative facts whatsoever." The court dismissed the original complaint for the same reason. The directors argue that the verification requirement of rule 23.1 remains unsatisfied. The issue is whether the district court abused its discretion in finding that Lewis' original complaint failed to satisfy rule 23.1's verification requirement. *Cf. Weiss*, 520 F.Supp. at 1100 (demand requirement of rule 23.1 must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight).

Lewis argues that he relied upon the factual investigation of his attorney Markowitz and that Markowitz conducted a very substantial investigation before filing this suit. Lewis admitted that his "investigation" of the subject matter of the instant case was limited to his reading of a single journal article and that he verified the complaint two days after the newspaper article was published. The directors argue that Lewis' failure to conduct his own investigation of the allegations of the complaint placed him in direct violation of the verification requirements of rule 23.1. We must decide whether reliance solely on a journal article can be the basis for verification of a stockholder derivative complaint.

The verification requirement "was originally adopted and has served since in part as a means to dis-

courage 'strike suits' by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them." *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 371 (1966). In *Kauffman*, the court, in discussing the demand requirements of rule 23.1, reminded:

> For lawyers and judges accustomed to the liberalized "notice" pleading of the Federal Rules, F.R.Civ.P. 8, a brief review of the background of Rule 23.1 is in order. Rule 23.1 is not an ordinary, but an exceptional rule of pleading, serving a special purpose, and requiring a different judicial approach.

479 F.2d at 263. In *Porte v. Home Federal Savings & Loan Association*, 409 F.Supp. 752, 754 (N.D.Ill. 1976), the court stated: "Before a court can proceed with a derivative suit, it must be assured that the plaintiff or some other person has investigated the charges and found them to have substance." On the other hand, it should be remembered that "the verification requirement of Rule 23.1 is intended only to clear the courts of strike suits and not to be a general impediment to shareholder derivative actions." *Markowitz v. Brody*, 90 F.R.D. 542, 549-50 n.2 (S.D.N.Y. 1981) (citing *Surowitz*).

Reliance on an article in *The Wall Street Journal* is not reliance on an insubstantial or meaningless investigation. Plaintiffs and their attorneys need not make further expenditures to prove independently that which may be read with some confidence of truthfulness and accuracy in a respected financial journal. We believe that such a basis satisfies the policy behind rule 23.1 of discouraging strike suits. Neither the district court nor the defendants have identified any material errors or irregularities in the averments of the complaint. Without evi-

dence that the allegations are without foundation, the district court's finding that the original complaint was not verified is an abuse of discretion. Likewise, the refusal to permit the legally sufficient amended complaint to be filed is an abuse of discretion. Because we find Lewis' investigation alone sufficient to satisfy the verification requirement, it is unnecessary to consider the investigation undertaken by his counsel, Markowitz.[8]

D.

Rule 23.1 provides in part: "The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association." The district court noted in its memorandum accompanying its order that "[d]efendants also allege in their dismissal motions that it appears that plaintiff does not fairly and adequately represent the interests of the shareholders as he has but one hundred shares of the corporate stock as compared with nearly eight million outstanding." Although the district court did not specifically rely on a finding that Lewis was an inadequate representative of Hammermill and its shareholders in denying Lewis' motion to amend his complaint, the proposed amended complaint will not effect Lewis' status as representative of Hammermill and its shareholders. We believe that it is thus necessary to determine whether the district court's decision may be affirmed because Lewis cannot fairly and adequately represent the interests of the Hammermill shareholders. *See Owen v. Modern Diversified Industries,*

[8] We note that Lewis' complaint contains many facts and much information that are not in the journal article. For purposes of our decision, however, we will assume that the heart of the complaint in need of verification—the allegations regarding the settlement—was solely derived from the article.

Inc., 643 F.2d 441, 443 (6th Cir. 1981) (abuse-of-discretion standard of review). The burden is on the defendant to demonstrate that the representation will be inadequate. *See Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 592-93 n.15 (5th Cir. 1979).

The fact that Lewis' investment is comparatively small is irrelevant. *See Marshall v. Spong & Co.*, 321 F.Supp. 1310, 1312 (W.D.Pa. 1971). Where a derivative plaintiff's financial security interest is minimal, the defendant's protection for an alleged "strike suit" is to request the court to order the plaintiff to post security for costs or expenses. *See Levine v. Bradlee*, 378 F.2d 620, 623-24 (3d Cir. 1967). Thus, there is no basis for dismissing Lewis' complaint simply because he only owns a few shares of Hammermill's stock.

In *Wetzel v. Liberty Mutual Insurance Co.*, 508 F.2d 239, 247 (3d Cir. 1975) (class representation under rule 23(a)(4)), *cert. denied*, 421 U.S. 1011 (1975), this court stated: "Adequate representation depends on two factors: (a) the plaintiff's attorney must be qualified, experienced, and generally able to conduct the proposed litigation, and (b) the plaintiff must not have interests antagonistic to those of the class." Similar tests have been used for rule 23.1. *See Schupack v. Covelli*, 512 F.Supp. 1310, 1312 (W.D.Pa. 1981); *Denny v. Carey*, 73 F.R.D. 654, 656 (E.D.Pa. 1977). *Cf. G.A. Enterprises, Inc. v. Leisure Living Communities, Inc.*, 517 F.2d 24, 26 n.3 (1st Cir. 1975) (cases decided under rule 23(a)(4) may be used in analyzing the requirements of rule 23.1). Defendants do not argue that the two factors in *Wetzel* are not met in this case. Indeed, "plaintiff Lewis' past experience suggests that he and his counsel will be able to provide vigorous advocacy for the members of the class which he now

seeks to represent." *Markewich v. Adikes*, 76 F.R.D. 68, 75 (E.D.N.Y. 1977).

At his deposition, taken over four months after he verified the complaint, Lewis displayed a complete ignorance of facts concerning the transaction that he was challenging. The directors argue that plaintiff shareholder cannot fairly and adequately represent the interests of the other shareholders unless he has knowledge of the material facts in support of his claim. There are certainly cases that support such a requirement. *See Roussel v. Tidelands Capital Corp.*, 438 F.Supp. 684, 688 (N.D.Ala. 1977). *See also Apanewicz v. GMC*, 80 F.R.D. 672, 679 (E.D.Pa. 1978) (Fed.R.Civ.P. 23(a)(4)). We do not believe, however, that such a requirement makes vigorous representation of the class any more likely. The adequacy-of-representation test is not concerned whether plaintiff personally derived the information pleaded in the complaint or whether he will personally be able to assist his counsel. We believe that the requirements in *Wetzel* are sufficient to insure adequate representation and decline to require anything further. Lewis and his attorney are quite able to represent the shareholders' interests in this case. We thus conclude that the district court's refusal to permit a motion to amend, on this or any of its stated grounds, was an abuse of discretion.

III.

Impartiality and the appearance of impartiality in a judicial officer are the sine qua non of the American legal system. In *Commonwealth Coatings Corp. v. Continental Casualty Co.*, 393 U.S. 145, 150 (1968), the United States Supreme Court stated: "[A]ny tribunal permitted by law

to try cases and controversies not only must be unbiased but also must avoid even the appearance of bias." Lewis argues that, on remand, this court should order, under its supervisory power and pursuant to 28 U.S.C. § 455 (1976), that the case be assigned to another judge. Without pausing to consider whether there is a basis for legal disqualification, we conclude that the undisputed facts dictate that the appearance of justice will be served only if the assignment to another judge is made, and we will, pursuant to our supervisory power, so direct.

IV.

The order of the district court will be reversed and the case remanded for assignment to another judge.

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

APPENDIX B

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

HARRY LEWIS, Plaintiff v. HENRY CURTIS, ALBERT F. DUVAL, ROGER S. AHLBRANDT, FRED HERBOLZHEIMER, JR., BERNARD S. KUBALE, WILLIAM G. KUHNS, LOUIS H. RODDIS, JR., CHARLES M. WILLIAMS AND HAMMERMILL PAPER COMPANY, Defendants,	Civil Action No. 80-125K Erie

MEMORANDUM AND DISMISSAL ORDER

The complaint in this derivative action case was filed August 4, 1980. Plaintiff Harry Lewis is a member of the Bar of the State of New York and a citizen and resident of New York. Defendants are Hammermill Paper Company, a corporation, and its officers and directors. Diversity of citizenship is averred and admitted, and the law of Pennsylvania applies as the cause of action complained of occurred in the Western District of Pennsylvania. In due course answers were filed by defendants and discovery was commenced by both parties. In accordance with the practice of the Judges of this Court, a status conference was held on November 18, 1980, at Erie. At that conference it developed that plaintiff Harry Lewis owned 100 shares of stock but in the hands of a broker and not registered with the corporation on the day suit was filed. It was revealed also at the hearing that Hammermill has slightly less than eight million shares of stock outstanding.

The transcript of the status conference hearing indicates that Messrs. Michael P. Malakoff and Abraham I. Markowitz appeared on behalf of plaintiff, and that Richard R. Nelson, II, and John Wolford appeared for the corporation and one individual defendant, and the transcript also shows that a rather amiable discussion was had with respect to motions, interrogatories, and further discovery. But it was agreed at that hearing that no further discovery would be had until after the deposition of the plaintiff Harry Lewis had been taken. At that time also at least one of the individual defendants had not been served.

Thereafter and no doubt largely because of Lewis' deposition testimony this case took a sharp adversary aspect. For instance, on December 30, defendants noticed Michael P. Malakoff, Esq., one of the plaintiff's attorneys, for a deposition to be taken on January 13, 1981. Also on the same date the directors filed a motion to dismiss the complaint and on the next day, December 31, filed a motion to request the Court to establish a discovery period and a briefing schedule in connection with the motion to dismiss based upon defendants' contention that plaintiff failed to meet the requirements of Fed. R. Civ. P. 23.1 and requested also that discovery be stayed pending the resolution of the motion to dismiss. On January 7, 1981, Mr. Malakoff filed a motion for protective order and to quash the subpoena directing him to appear for his deposition.

The motions to dismiss came to my attention, and as the Judge to which this case was assigned, it became clear that further discovery proceedings should be held in abeyance pending a court-conducted pretrial investigation to determine whether the complaint was proper under Rule 23.1. My cursory examination of the complaint

led me to question whether the complaint had been verified at all as required by the rule and also whether it had been signed by an attorney of record in his individual name as required by Rule 11. These issues were reviewed preliminarily in my Order entered January 8, 1981, and directing Harry Lewis and both of his counsel to be present. It turned out, however, at this hearing on January 20, that Mr. Malakoff was present, but neither Mr. Markowitz nor Mr. Lewis appeared. However, the hearing was worthwhile as Mr. Malakoff indicated on the record his relationship to the so-called signing of the complaint. He stated that he was out of town when the complaint arrived from New York on August 4. He stated he talked for approximately eighteen minutes to his associate Richard A. Finberg, "to assure myself that the complaint was in proper order." He said he understood the complaint was verified by Mr. Lewis, who was an attorney of some thirty-five years and had participated in over one hundred similar cases and that Mr. Markowitz drew the complaint. Mr. Malakoff indicated that he had portions of the complaint read to him over the telephone and, being questioned by the Court, declined to respond to my question as to whether he had made any independent investigation of the facts which would warrant the charges specified in the complaint. He declined to answer on the ground of work product.

It is noticed at this point that the Lewis deposition was filed with the Clerk on January 19, 1981, but reference to his testimony had been made in the motions to dismiss. As the transcript will reveal from this point on Mr. Malakoff as well as Messrs. Lewis and Markowitz, took the position that plaintiff and his counsel in this case were not bound to support the allegations of the complaint with any independent investigation. They

have consistently taken the position that the allegations of the complaint are sufficient and have disparaged attempts of defendants to dismiss this action and have contended before me that Markowitz does not need to reveal the source of his information as to the directors' dereliction with respect to the payment the corporation made to Icahn. They have refused to answer questions in open court on the ground of work product and the ground of privileged communication between client and counsel. But Mr. Lewis is forthright in saying in his deposition and in open court that he relied on Mr. Markowitz to prepare the complaint and to furnish the information necessary and required under Rule 23.1. Thus the case stands on the motions to dismiss at the conclusion of the hearing held May 7, 1981.

In the motions to dismiss and briefs, counsel have cited *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363, 371 (1966). That case is authority for the proposition that in certain instances a court can stop all proceedings in a derivative case and conduct its own pretrial investigation to determine:

> "whether the plaintiff had falsely sworn either that the facts alleged in the complaint were true or that he had information which led him to believe they were true."

After the January 20, 1981, hearing at which time Messrs. Lewis and Markowitz failed to appear, I directed a further hearing to be held February 3, 1981, at which time it was directed that Messrs. Lewis and Markowitz should be present in open court. On account of a snowstorm, that hearing was delayed until May 7, 1981, at which time Messrs. Lewis and Markowitz appeared and were sworn and testified. The evidence taken at that hearing has been transcribed. In my view plaintiff Lewis

is the only person on the plaintiff's side who has been forthright and has credibility. He admits he knew nothing about the case until he read the Wall Street Journal article, which appeared in its issue of July 30, 1980, and which is attached hereto and marked Court Exhibit 1 and Lewis' deposition 2. It is unnecessary to elaborate on his deposition testimony and on his hearing testimony except to say that he left everything to Mr. Markowitz, his lawyer. They have had something over seventy-one lawsuits involving derivative action cases or class action cases, but he stated but three of which went to trial. Markowitz admitted the number of suits filed by him on behalf of Mr. Lewis and claimed millions of dollars have been recovered in the various lawsuits.

Thus based on the whole record before me, this case must be and is a strike suit. In the *Surowitz* case the reason for Rule 23.1 is discussed, and strike suits are abhorred. This civil action and complaint will be dismissed.

Among reasons for dismissal are the following:

1. Rule 11 had been violated. That rule requires that the complaint must be signed by an attorney in his individual name and his signature constitutes a certificate by him that he has read the pleading; that to the best of his knowledge, information, and belief there is good ground to support it.

Malakoff not only did not sign the complaint, but his own statement is that he had no information on which he could form a belief that there is good ground to support it. The whole situation of his office receiving the complaint on August 4, and filing it the same date indicates the haste and hurry in which these parties sought to commence this strike suit. On the face of it, what was

signed must have been with intent to defeat the purpose of Rule 23.1. Keeping in mind that this case was one in which the complaint should make allegations with particularity and be verified, Mr. Malakoff's handling of the so-called signing and filing is but a sham, and the complaint should be stricken by reason of the violation of Rule 11.

2. There has been no verification of the complaint as required by Rule 23.1. Again one must refer to the Lewis and Markowitz testimony and the statement by Mr. Malakoff. Markowitz is the attorney for Lewis and is also a Notary Public. He prepared the complaint and the jurat. He had Lewis take his affidavit prior to the signing of the complaint. Under Lewis' own testimony, he had no idea as to whether the facts in the complaint were correct or based on any credible information as to any dereliction of Hammermill or its officers and directors. Such a jurat by a lawyer, who prepares a complaint not in compliance with the rule and then gets the client to take an affidavit thereto, is a nullity and is not the verification as required by Rule 23.1. It is noticed also that the jurat is dated August 1, 1980. Judge Knox did not dismiss the Icahn case until July 31, 1980. Again this so-called verification illustrates the haste of counsel in filing this strike suit. Furthermore, the execution of the jurat by the attorney who drew the complaint but did not sign it contrary to the practice in Pennsylvania amounts to a nullity by itself. See *Hassell v. Walker*, 45 D&C 78 (1942).

3. The motions of all defendants allege that the complaint fails to comply with Rule 23.1, in that it does not allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or the shareholders; and it fails also to advance reasons for his failure to obtain the action or for not making the

effort. Defendants also allege in their dismissal motions that it appears that plaintiff does not fairly and adequately represent the interest of the shareholders as he has but one hundred shares of the corporate stock as compared with nearly eight million outstanding. In numerous decisions, particularly commencing with the *Surowitz* case, the Courts have outlined the purpose for the amended rule 23.1. It is hornbook law that the facilities of the Court cannot be used for strike suits, and before the Court can proceed with a derivative suit it must be assured that plaintiff or some other person has investigated the charges and found them to have substance. See *Porte v. Home Fed. S. & L. Ass'n. of Chicago*, 409 F.Supp. 752. In the instant case, counsel for plaintiff seeks to excuse the lack of particularity and demand on the Board of Directors to the fact that the directors are responsible for the payment complained of and that any demand on them would be futile. But the Courts have characterized such an excuse as a conclusion only and insufficient compliance with the rule. In a recent Court of Appeals' case, *Cramer v. General Tel. & Electronics Corp.*, 582 F.2d 259, 276 (1978), the Court referred to a case tried by me some years ago in *Shlensky v. Dorsey*, 574 F.2d 131 (1978), and said:

> "... we affirmed a district court's dismissal of a defendant in a derivative action on the ground that the amended complaint failed to allege either an adequate demand on the corporate directors to sue that defendant or a sufficient reason for failing to make that demand."

Also in this regard as to particularity and lack of demand in *In Re Kauffman Mutual Fund Actions*, 479 F.2d 157 (1973), the Court lists insufficient allegations on page 264, [5] 1, [8] 2, and [9] 3, which are italicized:

[5] 1. *An allegation of domination and control, unsupported by underlying facts, does not satisfy the requirement of particularity.*

[8] 2. *The fact that the named defendants participated is not enough to excuse demand upon the directorate.*

[9] 3. *Approval by the directors of action alleged to be injurious to the corporation is not sufficient to excuse demand, except in circumstances not here alleged.*

The foregoing are statements by Judge Aldrich and compel dismissal of the complaint by reason of the failure of the complaint to make the averments required under the rule. The failure to abide by Rule 23.1 alone warrants dismissal of this case which can be anchored to the face of the complaint alone as being deficient.

Finally, in terminating this discussion, the statement of Mr. Markowitz at the hearing on May 7, is revealing. He was asked a question:

"Q. Did you make any attempt to contact representatives of Hammermill to determine why Hammermill had agreed to the settlement agreement?

"A. No.

"Q. Did you make any attempt to contact representatives of the Icahn group to determine why the Icahn group agreed to the settlement?

"A. No, I did not. *In fact, I did not make any investigation. I think the Wall Street Journal article itself, as far as I'm concerned, was sufficient basis for bringing a lawsuit.* [Emphasis Supplied].

"THE COURT: You based your judgment, then, on the Wall Street article?

"A. On forty years of experience, your Honor, please." [TR. May 7, 1981, page 52].

At the conclusion of the hearing on May 7, I orally announced dismissal of this civil action. However, I did request counsel for defendants to submit a summary of the evidence supporting dismissal to facilitate a written decision. But on reflection over the weekend and on return to my chambers on May 11, the transcript of the May 7, hearing became available. The case I expected to try on May 12 settled. Thus, I was free to prepare this written decision without any further submission by counsel and have done so.

The foregoing Memorandum includes my Findings and Conclusions as permitted under Rule 52.

The motions of plaintiff to file an amended complaint and to seek from Hammermill its list of stockholders has not been overlooked, but the amended complaint as submitted is conclusory and lacks particularity and demand and is not supported by any investigative facts whatsoever. The motion to amend will be denied, as will the motion to compel Hammermill to provide the list of stockholders.

A Judgment Order follows.

IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF PENNSYLVANIA

HARRY LEWIS, Plaintiff v. HENRY CURTIS, ALBERT F. DUVAL, ROGER S. AHLBRANDT, FRED HERBOLZHEIMER, JR., BERNARD S. KUBALE, WILLIAM G. KUHNS, LOUIS H. RODDIS, JR., CHARLES M. WILLIAMS AND HAMMERMILL PAPER COMPANY, Defendants,	Civil Action No. 80-125K Erie

JUDGMENT ORDER

AND NOW, *May 13, 1981,* for the reasons mentioned in the foregoing Memorandum, the motions of defendants to dismiss this civil action and complaint are granted, and the complaint is dismissed with prejudice.

AND FURTHER, the motion to amend the complaint and to join additional parties as defendants is denied.

AND FURTHER ALSO, the motion by plaintiff to secure a list of defendant's stockholders is denied.

IT IS SO ORDERED.

/s/ JOSEPH P. WILLSON

Joseph P. Willson, *Senior District Judge*

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APPENDIX C

12 THE WALL STREET JOURNAL, Wednesday, July 30, 1980

Hammermill Narrowly Wins Proxy Fight With Carl Icahn, and Pays Him $750,000

By a Wall Street Journal Staff Reporter

ERIE, Pa.—Hammermill Paper Co. narrowly won its four-month-long proxy battle with Carl C. Icahn, but the New York-based investor walked away from the fight with a $750,000 payment from the company.

The paper maker said yesterday that in the final tabulation of voting from its May 13 annual meeting, the company's candidates for reelection to two board seats—Albert F. Duval, president and chief executive officer of Hammermill, and Henry Curtis, chairman of Interstate Business Products Inc.—received 4,336,491 votes.

Under a cumulative voting procedure in which shareholders were allowed two votes per share owned, Mr. Icahn received 4,-330,033 votes—6,000, or 1%, fewer than for the management slate—in his bid for a board seat.

Would Seek Buyer

Mr. Icahn, who owns about 900,000 shares, or 10.2% of Hammermill, had said he would seek a buyer for the company if he gained a seat on the board.

But Messrs. Duval and Curtis were assured victory by the investor's withdrawal of his claimed right to vote 70,000 shares he had borrowed on the record day for shares eligible to vote at the annual meeting. Under the assumption that Mr. Icahn would control these shares, Hammermill had announced May 21 that a preliminary tally showed the investor received "barely more than one-third the vote" he needed to win a seat on the board.

In the settlement, Hammermill and Mr. Icahn agreed to drop "all pending litigation against one another," including Hammermill's charge that Mr. Icahn had "no right to vote" the 70,000 borrowed shares.

Mr. Icahn and his associated investors also agreed to avoid any proxy fights with Hammermill at least until after its next annual meeting and to give the company a right of first refusal on the Icahn group's block of stock until that time.

"In consideration of these matters," Mr. Icahn got $750,000 from Hammermill.

"I reached a point where I was looking down the road at tremendous legal fees no matter what happened," said Mr. Icahn. "And the whole problem was that Hammermill management wasn't using their own money, they were using their treasury's money. They were willing to pay me a certain amount of money, so I took it."

Cost Icahn $1.2 Million

Mr. Icahn said the proxy contest with its attendant litigation expenses already had cost him and his associated investors $1.2 million. But he said he felt he wouldn't have lost his court case against Hammermill—"in fact, I felt the company voted some stock they didn't have the right to vote," he said.

Donald B. Leslie, Hammermill's executive vice president, said Mr. Icahn's borrowing of 70,000 votes was improper "just on the face of it." But he said a court validation of Mr. Icahn's purchase would have won the proxy fight for him.

Mr. Icahn said he feels Hammermill's stock is "still undervalued" and that the company is a "good acquisition candidate," but he didn't say whether he would sell his Hammermill holdings or buy more shares in the paper maker. The company said it didn't have any agreement to buy Mr. Icahn's shares.

An industry analyst said he thinks Hammermill, however, will soon buy the investor's portion of the company. "History says that Mr. Icahn doesn't own stock as a long-term investment. He takes it to facilitate the sale of a company, and then turns around and sells it at a profit," the analyst said.

81-2224

No. 81-2055

Office - Supreme Court, U.S.
FILED
JUN 24 1982
ALEXANDER L. STEVAS, CLERK

IN THE

Supreme Court of the United States

October Term, 1981

HENRY CURTIS, ALBERT F. DUVAL, ROGER S. AHLBRANDT, FRED HERBOLZHEIMER, JR., BERNARD S. KUBALE, WILLIAM G. KUHNS, LOUIS H. RODDIS, JR., CHARLES M. WILLIAMS and HAMMERMILL PAPER COMPANY,

Petitioners,

vs.

HARRY LEWIS,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

RESPONSE TO PETITION FOR WRIT OF CERTIORARI

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Questions Presented

I. Whether Plaintiff Lewis' reliance on an article in The Wall Street Journal renders his verification inadequate to satisfy Rule 23.1?

II. Whether the Court correctly held that no demand upon the Directors to bring suit is necessary where the Amended Complaint sets forth in detail a self interested transaction participated in and approved by all Directors as part of a scheme to perpetuate their control of the Company?

III. Whether the decision below that Plaintiff adequately represents the interests of other stockholders is erroneous?

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IN THE

Supreme Court of the United States

October Term, 1981

No. 81-2055

HENRY CURTIS, ALBERT F. DUVAL, ROGER S. AHLBRANDT, FRED HERBOLZHEIMER, JR., BERNARD S. KUBALE, WILLIAM G. KUHNS, LOUIS H. RODDIS, JR., CHARLES M. WILLIAMS and HAMMERMILL PAPER COMPANY,

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vs.

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Respondent.

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RESPONSE TO PETITION FOR WRIT OF CERTIORARI

Statement of the Case

The only material error in Petitioners' statement of the case is the implication that no investigation was conducted by Plaintiff or his attorney prior to filing suit, other

than reading an article in the Wall Street Journal. (Petition at pp. 3, 5). As the Court of Appeals observed, Lewis' attorney, Markowitz (now deceased) produced his pre-suit investigatory file and testified that between July 30 and August 1, 1981, he examined: Icahn & Company's [hereafter "Icahn"] 13-D form, and amendments thereto (on file with the Securities and Exchange Commission), Hammermill Paper Company's [hereafter "Hammermill"] 10-K for 1979, proxy statements for Icahn and Hammermill, the Complaints filed in Court in connection with the proxy contest, and the files of a similar case in which Lewis was involved. Appendix A at 6a. Markowitz, however, respectfully declined to disclose his mental processes by which he concluded that litigation was warranted based on F.R.Civ.P. 26(b)(3), which explicitly states "... the Court shall protect against the disclosure of mental impressions, conclusions, opinions or legal theories of an attorney ..." See also, *United States vs. Nobles*, 422 U.S. 225, 238-39 (1975) and *Upjohn Company vs. United States*, 449 U.S. 383 (1981) which have broadly interpreted the scope of protection given by Rule 26(b)(3).[1]

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[1] In *Upjohn*, this Court protected against disclosure facts provided to in-house counsel from a witness, holding:

> "Rule 26 accords special protection to work product revealing the attorney's mental processes. The Rule permits disclosure of documents and tangible things constituting attorney work product upon a showing of substantial need and inability to obtain the equivalent without undue hardship. This was the standard applied by the magistrate, Pet. App. 26a-27a. Rule 26 goes on, however, to state that '[i]n ordering discovery of such materials *when the required showing has been made*, the Court *shall protect* against disclosure of the mental impressions, conclusions, opinions or legal theories of an attorney or other representative of a party concerning the litigation.'" *Id.* at 400 [Emphasis added].

Because of the above claim to privilege, although properly based on Rule 26(b)(3) and this Court's interpretations of that rule, the Trial Court announced orally at a "preliminary investigation" proceeding that it intended to dismiss the action with prejudice. (Appendix A at 7a; Appendix B at 2b).

Since the Court of Appeals found Plaintiff Lewis' investigation alone sufficient to satisfy the verification requirement, it did not reach the question of whether attorney Markowitz's investigation afforded a sufficient basis for Plaintiff Lewis' verification of the Complaint, nor whether Markowitz's claim to attorney work product was proper.[2] The Court of Appeals held that Plaintiff need not independently substantiate information contained in a respected financial journal before verifying his complaint:

> "Reliance on an article in *The Wall Street Journal* is not reliance on an insubstantial or meaningless investigation. Plaintiffs and their attorneys need not make further expenditures to prove independently that which may be read with some confidence of truthfulness and accuracy in a respected financial journal. We believe that such a basis satisfies the policy behind Rule 23.1 of discouraging strike suits. Neither the district court nor the defendants have identified any material errors or irregularities in the averments of the complaint. Without evidence that the allegations are without foundation, the district court's finding that the original complaint was not verified is an abuse of discretion. . . ." Appendix A at 17a-18a.

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[2] The Court of Appeals noted:

> "We note that Lewis' complaint contains many facts and much information that are not in the journal article. For purposes of our decision, however, we will assume that the heart of the complaint in need of verification—the allegations regarding the settlement—was solely derived from the article." Appendix A at 18a, Fn. 3.

REASONS FOR DENYING THE WRIT

Summary of Argument

This case raises no exceptionally unusual or difficult issues. The courts of appeals are not in conflict over the questions raised herein; nor does the Court of Appeals decision herein conflict with any decisions of this Court. The allegedly "conflicting" decisions are readily distinguishable, and there is no reason to believe that any other appellate court would have resolved this case differently.

This Court's decision in *Surowitz vs. Hilton Hotels Corporation*, 383 U.S. 363 (1966) permits verification, upon information and belief, of a complaint in a shareholder derivative action, where the verification is based on sources of information reasonably believed to be accurate. Moreover, there has been no showing in this case that the Complaint and amended Complaint were inaccurate in any material respect.

Rule 23.1, F.R.Civ.P., clearly contemplates that demand on the directors prior to filing suit is not required in *all* cases. Clearly, the present case falls within that narrow category of cases in which demand is not required where it is alleged that a majority of the Board of Directors participated, authorized and approved of the use of corporate funds to pay off an outsider to terminate a proxy contest to secure their own position and where a pattern of prior acts furthering the objective of frustrating outside attempts to obtain control is also alleged.

Petitioners fail to demonstrate that Plaintiff-Respondent is other than an adequate representative of the shareholders, and have failed to demonstrate that Plaintiff has any antagonistic interests to that of the shareholders.

The District Court made an unwarranted and unprecedented dismissal of Plaintiff's case for reasons totally unrelated to the merits of this litigation. The Court of Appeals restored justice by reversing, and in doing so, directed that the case be reassigned to another district judge (Appendix A at 20a-21a). It is respectfully submitted that no review by this Court is warranted.

I. Plaintiff Lewis' reliance on an article in the Wall Street Journal does not render his verification inadequate to satisfy Rule 23.1.

Petitioners' contention that the decision of the Court below conflicts with this Court's decision in *Surowitz vs. Hilton Hotels Corporation*, 383 U.S. 363 (1966) is completely erroneous.

As Petitioners correctly point out, F.R.Civ.P. 23.1 requires that a complaint in a shareholder's derivative action be verified. This is, of course, in contrast to all other federal civil actions, which need not be verified but need only be signed by counsel. The purpose of the 23.1 requirement of verification was articulated in *Surowitz* as "a means to discourage 'strike suits' by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them." *Id.* at 371.

In furtherance of this purpose, Mrs. Surowitz, a Polish immigrant with a very limited English vocabulary and practically no formal education, *Id.* at 368, was held to have satisfied Rule 23(b)[1] even though she had almost no knowledge of the basis of the allegations in the complaint but acted entirely on the advice of her investment counselor and attorney. The District Court in *Surowitz* dismissed the action, and the Court of Appeals affirmed

[1] Now Rule 23.1.

concluding that plaintiff's verification of the complaint was false because she swore to the verity of alleged facts of which she was wholly ignorant. 342 F.2d 596-606. This Court, in reversing and remanding the case for trial on the merits, held that no requirement of personal knowledge of the facts on the part of the complainant was necessary:

> "It is difficult to believe that anyone could be shocked or harmed in any way when, in light of all these circumstances, Mrs. Surowitz verified the complaint, not on the basis of her own knowledge and understanding, but in the faith that her son-in-law had correctly advised her either that the statements in the complaint were true or to the best of his knowledge he believed them to be true." 383 U.S. at 370-71.

Thus, it is clear under *Surowitz* that there is no requirement that the plaintiff have *personal* knowledge of the facts he verifies in his complaint and that he is permitted to rely on sources of information he reasonably believes to be accurate. The Court of Appeals in this case followed *Surowitz* in holding that Plaintiff's reliance on The Wall Street Journal article alone was sufficient basis to satisfy the verification requirement of Rule 23.1. The Court of Appeals therefore found it unnecessary to consider the additional investigation undertaken by Lewis' counsel[4] (Appendix A at 18a). The various District Court decisions cited by Petitioner (Petition, p. 8, fn 8), cannot, and do not, undercut *Surowitz*.[5]

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[4] Lewis verified the complaint only after attorney Markowitz advised him of the results of his investigation. Appendix A at 3a.

[5] The dicta in *Waldman vs. Carey*, 82 F.R.D. 469, 471 (E.D.Pa. 1979), that the verification requirement is to discourage suits by derivative plaintiffs who have no reason to believe the allegations in the complaint are true, follows *Surowitz* and has no application to the present case where the plaintiff has good reason to believe the allegations in the complaint are true.

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No showing has been made that the complaint is not accurate in any material respect. Nor is there any reason to believe that a more extensive pre-suit investigation would have revealed any additional facts. Ultimately, this case will turn on questions of motive and intent, and pre-suit inquiry into these facts, made without the benefit of discovery taken under oath, would be an exercise in futility, especially since Petitioners were already litigating the legality of their position in *Icahn, et al. vs. Hammermill, et al.*, 80 Civ. 2080 (S.D.N.Y.) (allegations made that directors acted in self interest to retain control).

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In *Cohen v. Bloch*, (1979-80 Transfer Binder) Fed.Sec.L.Rep. (CCH) ¶97,176 (S.D.N.Y. Nov. 14, 1979), inquiry into the scope of the counsel's pre-suit investigation was held proper where plaintiff's deposition revealed she did not understand the complaint, and her attorney (who was the husband of plaintiff's stepdaughter) had recommended the investment initially and had informed plaintiff of the alleged actionable wrongs. In contrast, in the present case Plaintiff Lewis personally made the decision to invest, initiated the filing of the lawsuit, and fully understood the charges made in the complaint.

In *Rogosin vs. Steadman*, 65 F.R.D. 365 (S.D.N.Y. 1976), neither plaintiff actually initiated the litigation. One plaintiff signed the verification for the complaint at the request of an attorney, with no independent knowledge of or interest in the litigation, while the other plaintiff had never authorized institution of the suit and did not even know it had been filed until four years later.

Finally, *Porte vs. Home Federal Savings and Loan Association*, 409 F.Supp. 752, 754 (N.D.Ill. 1976), held simply that after removal of a derivative action from state to federal court, defendant could require plaintiff to verify the complaint, if he had not already done so, to comply with Rule 23.1.

The above cases are inapposite to the present case.

II. The Court correctly held that no demand upon the directors to bring suit is necessary where the amended complaint sets forth in detail a self interested transaction participated in and approved by all directors as part of a scheme to perpetuate the control of the company.

Admittedly, in formulating standards as to when demand upon the directors prior to bringing suit is excused, the various Courts of Appeals have approached the problem differently. However, it is clear that, notwithstanding Petitioners' contentions the Courts of Appeals for the First and Ninth Circuits, as well as all other appellate courts, would concur in the result reached in the case at bar.

The Court below concluded that in determining whether demand is necessary, the Trial Court should consider whether a demand would be likely to prod the directors to correct a wrong (Appendix A of 13a). The decision below agrees with and is in harmony with the majority view of all other appellate courts that mere approval of an allegedly injurious corporate transaction, absent self-interest or bias by a majority of the board, is insufficient to excuse demand. See *Greenspun vs. Del E. Webb Corporation*, 634 F.2d 1204, 1209-10 (9th Cir. 1980); *Heit vs. Baird*, 567 F.2d 1157, 1162 (1st Cir. 1977); and *In Re Kaufman Mutual Fund Actions*, 479 F.2d 257, 265 (1st Cir.) *cert. denied* 414 U.S. 857 (1973). But see *Liboff vs. Wolfson*, 437 F.2d 121, 122 (5th Cir. 1971) (*per curiam*) adopting a more liberal standard. See generally, Note, *The Demand and Standing Requirement of Stockholder Derivative Actions*, 44 U.Chi.L.Rev. 168, 176-77 (1976) (*Kaufman* represents the preferred view). Likewise, the Court below is in agreement with the unanimous view of the cases that the allegation that demand upon the directors would be futile because the directors "would be suing themselves" is not alone sufficient to excuse demand. See cases cited at Appendix A at 11a.

Petitioners argue, however, that the decision below conflicts with the Court of Appeals for the First Circuit's decision in *Heit v. Baird, supra*, which they contend requires district courts to consider (a) whether the transaction on its face is lacking in any proper corporate purpose, and (b) whether the directors are "interested". However, as the Court of Appeals for the First Circuit subsequently explained in *Untermeyer vs. Fidelity Daily Income Trust*, 580 F.2d 22, 23 (1st Cir. 1978), if a majority of the directors were interested in the transaction, no demand is necessary. As *Untermeyer* recognized, the distinction in *Kaufman, supra*, and *Heit* between actions that could, *prima facie*, serve a legitimate corporate purpose and those that could not, was made for the purpose of determining whether a participating trustee was sufficiently unconnected, or "disinterested" to be presumptively responsive to a demand, and not as a means of testing the substantive sufficiency of the complaint apart from that issue. *Id.* at 24.

Significantly, *Heit* itself held only that the district court did not abuse its discretion in determining that the facts pleaded did not make out with sufficient particularity misconduct that would excuse a demand on the directors. 567 F.2d at 1161. In *Heit*, the sale of stock challenged in the derivative action was not alleged with particularity to have been made at a grossly inadequate price, and nothing more erroneous than business judgment was thus asserted.[6] The Court in *Heit* therefore

[6] The fact that the language in one paragraph used to allege futility in *Heit* was substantially similar to language in this case (see Appendix A at 13a, fn. 2) is of no consequence. In *Heit*, the allegation that demand would have been futile, merely because the directors participated in, authorized and approved and were personally liable for the wrongs complained of, was not sufficient because nothing more than erroneous business judgment was alleged. In the present case, the allegations of participation, authorization and approval by the

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concluded that in the absence of a showing that a majority of the board engaged in a facially improper transaction, demand on the directors was required. *Id.* at 1162. In the present case, the *Heit* standard was readily met. As the Court of Appeals below summarized:

> "(1) all of the board engaged in a self interested act, i.e., the 'payoff' to retain control of Hammermill; (2) all of the board members are 'interested' in the transaction; and (3) there were prior acts furthering their objective to frustrate outside attempts to obtain control of Hammermill." Appendix A at 10a.

Nor does the recent Court of Appeals for the First Circuit decision in *Grossman vs. Johnson*, 674 F.2d 115 (1st Cir. 1982) aid Petitioners. There, a bald allegation of conflict of interest was "at best tenuous and conditional, not direct, stark, apparent and 'unmistakable' ", *Id.* at 124, and the Court held that to "charge a true conflict of interest the Plaintiff should have at least spelled out the likelihood of one, not left the court with the bare possibility" of one. *Id.* at 125.

Petitioners also claim a conflict with the Court of Appeals for the Ninth Circuit decision in *Greenspun vs. Del E. Webb Corporation*, 634 F.2d 1204 (9th Cir. 1980). Petitioners' assertion of a conflict is simply based on a misreading of *Greenspun*, which does not require that the transaction be completely devoid of corporate purpose. Rather, the fact that a particular transaction is completely undirected to a corporate purpose is one basis by which self-interest might be shown. Thus, *Greenspun* quotes with approval the Court of Appeals for the First Circuit standard as stated in *Kaufman, supra:*

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directors, included particularized allegations in other paragraphs that the directors engaged in a "payoff" to retain control of Hammermill; that a majority of the board members were "interested" in the transaction; and that there were prior acts furthering their objective to frustrate outside attempts to obtain control of Hammermill.

> "[w]here mere approval of corporation action, *absent self interest or other indication of* bias, is the sole basis for establishing the director's 'wrongdoing' and hence for excusing demand on them, plaintiff's suit should ordinarily be dismissed." (Emphasis added) 634 F.2d at 1210.

Where self-interest or other indication of bias is shown, as in this case, the fact that the transaction may, superficially, be directed at a corporate purpose, does not render demand necessary. The complaint failed in *Greenspun* because it merely alleged knowledge and participation by the directors, but failed to disclose acts by a majority of the board showing self interest *or* that the questioned acts were not directed to corporate purposes. In the present case, self interest of the majority of the board of directors has been alleged with particularity, *i.e.*, to retain their positions with Hammermill, and prior acts furthering that end are also alleged (See Appendix A, 9a to 10a).

In sum, the decision below is consistent with all other courts of appeals' decisions, and the cases cited by Petitioners would not require a contrary result. Rule 23.1 clearly contemplates some circumstances under which demand upon the directors is excused. If demand under Rule 23.1 is not excused in this case, it is difficult to imagine any case in which demand need not be made. Here, the majority of the board of directors caused the corporation to pay a third party to terminate a proxy contest for the purpose of entrenching themselves as directors and maintaining control of the Company with the attendant financial benefits to themselves. The amended complaint demonstrates a factual pattern which itself is strong circumstantial evidence of an intention to direct corporate affairs in the directors' own self interest.

Since demand is clearly excused herein, this case is not an appropriate vehicle for this Court to delineate the fine line between situations where demand is necessary and situations where it is not. An attempt to delineate that line in this case would require this Court to speculate about factual patterns that are not before it, contrary to the sound policy of deciding only those matters that are necessary, when actually presented in a case or controversy. The present case can readily be resolved correctly by denial of the Petition for a Writ of Certiorari.

III. The decision below that Plaintiff adequately represents the interests of other stockholders is not erroneous and does not conflict with decisions of other Courts of Appeals.

The Court of Appeal's opinion states that at Plaintiff Lewis' deposition taken over four months after he verified the Complaint he "displayed a complete ignorance of facts concerning the transaction he was challenging." (Appendix A at 20a). Petitioners argue that for this reason alone, Plaintiff cannot be a fair and adequate representative of the interests of other shareholders. The Court of Appeals rejected that view and concluded that the adequacy of representation standards applicable to Rule 23 class actions are also applicable to shareholder derivative actions under Rule 23.1. The Court of Appeals therefore followed its opinion in *Wetzel v. Liberty Mutual Insurance Co.*, 508 F.2d 239, 247 (3d Cir. 1975), *cert. denied* 421 U.S. 1011 (1975), where it stated:

> "Adequate representation depends on two factors: (a) the plaintiff's attorney must be qualified, experienced, and generally able to conduct the proposed litigation, and (b) the plaintiff must not have interests antagonistic to those to those of the class." (Appendix A at 19a).

The cases relied upon by Petitioners are inapposite.

Initially, it is noted that the Court of Appeals' statement that Plaintiff Lewis was completely ignorant of facts at his deposition is not totally accurate. The District Court did not find that Lewis did not understand the facts concerning the transaction he was challenging,[7] and did not find Plaintiff Lewis' representation of the class inadequate in that respect. The Court of Appeals' statements as to Lewis' understanding of the facts are thus over-simplifications of the facts as found by the District Court. While Plaintiff Lewis lacked knowledge about certain of the facts concerning the challenged transaction, he unquestionably demonstrated a full comprehension of the theory of his lawsuit, and of his obligations as a representative of other stockholders.[8]

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[7] Because Lewis did not have first hand information but relied on the Wall Street Journal article and on the investigation by attorney Markowitz, the District Court did find that Lewis had "no idea as to whether the facts in the complaint were correct or based on any credible information . . . ." (Appendix B at 6b). This finding does not imply that Lewis did not understand the complaint or the nature of his action.

[8] Lewis' deposition reveals the following testimony upon examination by Attorney Zimet for Defendant-Petitioners:

> Q. . . . what was it that led you to conclude that this was not in the best interests of your company, Hammermill, at the time you read the article in The Wall Street Journal?
>
> A. Well, the impression that I got from the article was that Hammermill was giving away $750,000 of its funds in order to buy security for the officers and directors of the company.
>
> Appendix in Court of Appeals, p. 110a.
>
> * * * *
>
> Q. Do you have any basis for believing that the directors received any benefits in connection with the settlement of Mr. Icahn?
>
> A. Oh, yes.
>
> Q. What benefits are those?
>
> A. They secured their position in the company for the next couple of years at least.

(Footnote continued on following page)

None of the cases cited by Petitioners conflict with the Court of Appeals decision in this case. As both Courts in *Davis v. Comed, Inc.*, 619 F.2d 588, 593-94 (6th Cir. 1980) and *Rothenberg v. Security Management Company, Inc.*, 667 F.2d 958, 961 (9th Cir. 1982) acknowledge, whether a particular plaintiff will fairly and adequately represent the interests of other similarly situated shareholders as required by Rule 23.1 turns upon the total facts and circumstances of each case. Contrary to Petitioners' contention, both *Davis* and *Rothenberg* are substantially dissimilar from the present case, and neither opinion would require a different conclusion in the present case.

In *Davis v. Comed*, which Petitioners failed to even cite to the Court of Appeals, the Sixth Circuit Court of Appeals held that the District Court should not have permitted plaintiffs to represent other shareholders in a derivative action. In particular, plaintiffs there sought rescission of a corporate sale of real estate. However, the claim for rescission was unfounded; the other shareholders of the corporation overwhelmingly ratified the transaction; rescission would have subjected the corporation to substantial liability under an indemnity provision;

(Footnote continued from preceding page)

Q. How is that?

A. Mr. Icahn agreed not to engage in a proxy contest and try to take over the company for two years.

Appendix in Court of Appeals, p. 117a.

With respect to Mr. Lewis' obligations as a representative Plaintiff, he testified as follows:

Q. And can you describe for me generally what is it that you can understand your obligations to be?

A. My obligations are to proceed diligently, to act in good faith, in the best interests of the corporation.

Q. Do you also have any understanding as to what your financial obligations are in terms of—

A. My financial obligations would be to pay for disbursements in the event that I lost the case.

and, most importantly, the representative plaintiffs were acting as a front for others whose interests were inimical to the interests of the shareholders who plaintiffs purported to represent. Representative plaintiff Davis hoped to benefit personally through development of the real estate if rescission could be accomplished, perhaps obtaining as much as a $200,000.00 profit. In addition to this economic antagonism to the interests of other shareholders, Davis had been involved in other litigation with defendant in several courts, and the derivative action was just one more skirmish intended to create leverage in Davis' other law suits. Davis bears no resemblance to the present case.

In *Rothenberg*, the Court found plaintiff to be an inadequate representative to bring a shareholder derivative action based upon a totality of the circumstances. These facts included not only Mrs. Rothenberg's unawareness of the facts and issues involved in the suit, but her own acknowledgement that her lack of personal knowledge made her an inappropriate plaintiff to maintain the suit, her obvious unwillingness to learn about the suit by not acquiring more than a rudimentary understanding of the case, and the fact that she had little to gain from the suit and displayed no strong commitment to the action. Mrs. Rothenberg originally brought suit for her own personal benefit and not for the benefit of the corporation, since her objective was to recover her personal losses. She had not even read the amended complaint, and had no clear understanding that a recovery in the derivative suit went to the corporation and only indirectly benefitted shareholders.[9]

[9] In contrast to the present case where Plaintiff is himself an attorney and understands corporate matters, the *Rothenberg* plaintiff had not, until her third deposition, obtained even a rudimentary understanding of the nature of a derivative suit. Even then,

> "... responding largely to leading questions, she testified that a recovery in a derivative suit went to the corporation. Her grasp of the issues and facts, however, remained at best minimal. ...") *Id.* at 962, fn. 10.

Accordingly, the Court in *Rothenberg* held that the district court had not abused its discretion in granting a motion to dismiss on the grounds the plaintiff was an inadequate representative of the shareholders. The Court cautioned, however:

> "In rendering our decision, we do not mean to infer that a representative plaintiff must have a precise understanding of every fact or legal issue in a derivative suit. Nor do we intimate that the plaintiff will sacrifice his/her status as a representative plaintiff by granting an attorney broad discretion to investigate and pursue her claim . . . ." *Id.* at 963.

In contrast to *Rothenberg*, Plaintiff Lewis initiated the present action based upon his own reading and understanding of an article in The Wall Street Journal. Significantly, Lewis' "past experience suggest that he and his counsel will be able to provide vigorous advocacy for the members of the class he now seeks to represent." *Markewich vs. Adikes*, 76 F.R.D. 68, 75 (E.D.N.Y. 1977), Appendix A at 19a-20a. In the present case, Petitioners failed in their burden to demonstrate the Plaintiff's representation was not adequate. See Appendix A at 19a, citing *Smallwood vs. Pearl Brewing Co.*, 489 F.2d 579, 592-93 n. 15 (5th Cir. 1979).

In sum, Petitioners have demonstrated no conflict between the present case and any other appellate court decision. The adequacy of representation issue is clearly one to be decided on a case by case basis, in light of all the circumstances, as *Rothenberg* and *Davis* both acknowledge. Neither of those decisions are dispositive of the case at hand, and there is no conflict between the decision of the Court of Appeals for the Third Circuit in this case and the decisions of any other appellate court.

Conclusion

It is respectfully submitted that the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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